FINANCIAL PERFORMANCE OF ISLAMIC BANK IN MALAYSIA: DO BANK-SPECIFIC FACTORS MATTER?

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Abstract: *Healthy, resilient and sustainable profitability is vital in maintaining the stability of the banking system. Research on a bank's financial performance is an important tool towards improving performance, evaluating bank operations and determining management plans for the bank's survival in competitive markets. Therefore, this study was conducted to fill a demanding gap in the literature by providing new and the latest empirical evidence on the determinants of the financial performance of Islamic banking institutions in Malaysia. The objective of this paper is to examine the impact of bank-specific factors on Islamic banks' financial performance. The performance of Islamic banks is measured based on return on average assets (ROAA). An Ordinary Least Squares (OLS) panel data analysis on EViews 12 was used to analyse annual data from 16 Islamic banks in Malaysia for the period of 2012 to 2021. The results revealed that only bank size from bank-specific factors has a significant positive impact in determining banks' financial performance. Therefore, this research can be a hint at how banks should plan and measure the direction of their operations and assets management in order to sustain their performance.*

Keywords: Islamic Banking, Financial Performance, Bank-specific Factors.

1. Introduction

The performance of the financial system has a big impact on the growth of Islamic banking. In Malaysia, the overall Islamic banking industry in 2021 remained resilient and agile. The industry continued to grow at a faster pace than its conventional counterparts, although from a relatively smaller base. For instance, 42.5% of total loans and financing comes from Islamic banking with annual growth of 8.5%, compared with conventional only 2.1%. The same goes for the total deposits and investment accounts as Islamic banking's annual growth increased by 4% higher than conventional banking (BNM, 2021). According to previous studies, financial performance plays an important role in the economics of the whole country (Blejer, 2006). As reported by Bank Negara Malaysia (BNM) in 2021, the Islamic banking industry contributed higher growth of 27% in financing disbursed to micro, small and medium enterprises (MSMEs), also an increase in the contribution to Malaysia's GDP by 0.2%. For this study, the financial performance is referring to the profitability of the banks. A sound and profitable banking sector is able to endure negative shocks and contribute to the stability of the financial system (Athanasoglou, 2008). In addition, it also serves as an indicator of the

efficiency of bank management, as well as acting as a forecast for the financial crisis (Mohamad et al., 2019).

Today, the international and local environments in which Islamic banks operate are more competitive and challenging. Thus, it is important for Islamic banks to strengthen their business and financial performance in order to face the tough competition, especially from foreign and conventional banking that is more stable and established (Idris, et al., 2011). Even though the report by BNM above stated that the growth of Islamic banking is slightly higher compared to its conventional counterpart, it does not put the Islamic banking industry in a comfortable position. Besides, other major events that may tremendously affect the soundness and resilience of banks' financial health should be given careful attention. According to a new study by World Bank (2022), interest rates that hike in response to inflation by central banks around the world could trigger a global recession in 2023. As banks play a major role in the financial system, their soundness is a main concern for the financial stability of the country's economic system (ISRA, 2016). For these reasons, the understanding of profitability determinants is crucial.

Hence, this study will provide new empirical evidence on the factors that influence the financial performance of Islamic banks in Malaysia. The study will assist Islamic banking institutions to improve their financial performance and in turn, to develop their competitiveness and efficiency better or in line with the foreign or conventional banking system.

This paper is arranged as follows. The next section reviews the relevant literature according to the variables followed by a description of the data and methodology employed in this study. Section 4 explains the main findings followed by the conclusion of the study in the final section.

2. Literature Review

Bank-specific factors have shown their significance as drivers in determining the banks' performance. Many literatures have considered many factors including capital adequacy, operating efficiency, asset quality, liquidity and the size of the bank. Among the researchers, Mohamad et al. (2019) found the capital ratio is positive and affect significantly the profitability of Islamic banks, based on the regression analysis of the panel data set comprising 17 Malaysian Islamic banks over the period of 1994 to 2015. The same result can be found in the study by Chowdhury (2015); who suggested that Islamic banks should increase the portfolio of equity financing rather than debt financing.

Applying ratio of operating expenses to total assets as a proxy, the study by Alharbi (2017) on majority of Islamic banks in the world show that operating efficiency affected Islamic banks' profits positively. The same result can be found in the studies by Bashir (2003) on Middle Eastern countries banks and Haron (1997). For asset quality, the study by Samail et al. (2018) revealed that there is a significant negative relationship towards the performance of Islamic banking in Malaysia. The finding relied on the data collected from 12 Islamic banks in Malaysia from the year 2010 until 2016. It is supported with the similar finding from the studies by Srairi (2009), Vong and Chan (2006) and Wasiuzzaman and Tarmizi (2010).

In term of liquidity, the studies by Haron (1997) and Srairi (2009) on various Islamic banks worldwide and Islamic and conventional banks of Gulf Cooperation Council (GCC) countries respectively confirmed the significant positive relationship between profitability and liquidity. The similar result can be found on the study by Samail et al. (2018). For the bank

size, Idris et al. (2011), Masood and Ashraf (2012) and Abduh and Idrees (2013) found its significant in determining the profitability of Malaysian Islamic banks with positive relationship. It shows that the banks with larger assets obtain higher profitability. This relationship also found by Flamini et al. (2009) on the study of commercial banks in Sub-Saharan Africa and Samhan and Al-Khatib (2015) on Jordan Islamic Bank for both financial performance proxies; ROA (return on asset) and ROE (return on equity). The relationship between these variables is summarized in the framework as per Figure 1.

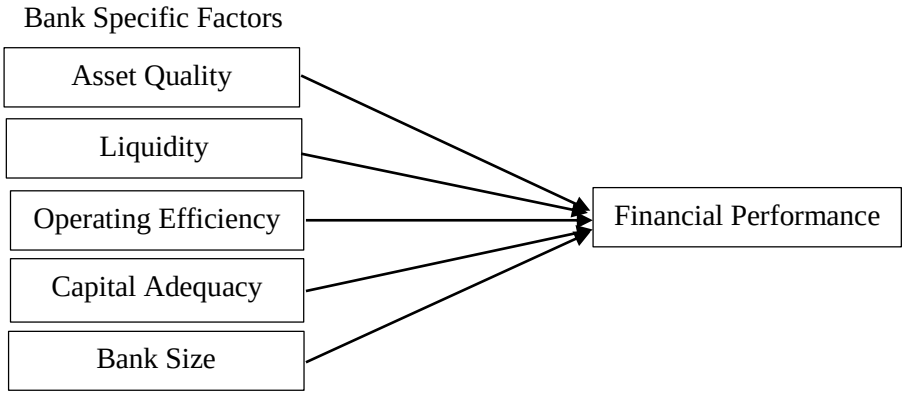

Figure 1. The Framework of the Relationship between Bank Specific Factors and Financial Performance

The following hypotheses were formulated to investigate and fulfil the research objectives.
H1: Capital adequacy (CA) has a significant impact on financial performance (ROAA) of Islamic banks in Malaysia.
H2: Operating efficiency (OE) has a significant impact on financial performance (ROAA) of Islamic banks in Malaysia.
H3: Asset quality (AQ) has a significant impact on financial performance (ROAA) of Islamic banks in Malaysia.
H4: Liquidity (LQ) has a significant impact on financial performance (ROAA) of Islamic banks in Malaysia.
H5: Bank size (BS) has a significant impact on financial performance (ROAA) of Islamic banks in Malaysia.

3. Methodology

3.1 Sample

The data used for this study is retrieved from income statement and balance sheet information of 16 Islamic banks in Malaysia published in Fitch Connect database. The data set is on annual basis that covers the period of 10 years from 2012 to 2021. By pooling all the data together, 160 observations were collected. The sample comprises of local and foreign Islamic banks incorporated in Malaysia as per listed by BNM (BNM, 2022) and can be referred at Table 1 below. This study employed panel data regression techniques using Ordinary Least Squares (OLS model) to analyse the determinants of financial performance of Islamic banks in Malaysia. The data is run using EViews 12.

Table 1. List of Islamic Banks in Malaysia

No.	Islamic Banks	Owners
1.	Bank Islam Malaysia Berhad	Local
2.	Bank Muamalat Malaysia Berhad	Local
3.	Affin Islamic Bank Berhad	Local
4.	Alliance Islamic Bank Berhad	Local
5.	AmBank Islamic Berhad	Local
6.	Hong Leong Islamic Bank Berhad	Local
7.	CIMB Islamic Bank Berhad	Local
8.	Maybank Islamic Berhad	Local
9.	MBSB Bank Berhad	Local
10.	Public Islamic Bank Berhad	Local
11.	RHB Islamic Bank Berhad	Local
12.	Al Rajhi Banking & Investment Corporation (Malaysia) Berhad	Foreign
13.	HSBC Amanah Malaysia Berhad	Foreign
14.	Kuwait Finance House (Malaysia) Berhad	Foreign
15.	OCBC Al-Amin Bank Berhad	Foreign
16.	Standard Chartered Saadiq Berhad	Foreign

3.2 Research Measurement

The descriptions of the dependent and independent variables, the measurement of the proxies and predicted coefficient signs are explained below and summarized in Table 2.

Table 2. Descriptions and Measurements of Variables

Variables	Notation	Descriptions/ Measurements	Expected Sign
Dependent			
Islamic banks financial performance	ROAA	Return on average total assets (Net income/ Average total assets (%))	
Independent			
Asset Quality	AQ	Loan loss provision / Gross loans (%)	-
Liquidity	LQ	Loans / Deposits and short-term funding (%)	+
Operating Efficiency	OE	Total operating expenses/ Total assets (%)	-
Capital Adequacy	CA	Equity / Total assets (%)	+
Bank Size	BS	Natural log of total assets	+ / -

3.3 Model of analysis

To identify the bank-specific factors that affect the Islamic banks financial performance in Malaysia, a linear regression model to be examined in this study is estimated as below;

$$ROAA_{it} = \alpha + \beta_1 AQ + \beta_1 LQ + \beta_1 OE + \beta_1 CA + \beta_1 BS$$

Where $ROAA_{it}$ is the return on average assets for bank i in year t, α is a constant. AQ, LQ, OE, CA and BS represent bank-specific variables of bank i in year t.

4. Results

4.1 Descriptive Statistics

The summary of the descriptive statistics or the preliminary features of the panel data is presented in the Table 3 below which describes the variables used in this study.

Table 3. Descriptive Statistics

	ROAA	AQ	LQ	OE	CA	BS
Mean	0.6425	2.3345	81.267	1.1830	8.7130	23.907
Maximum	1.4000	11.473	135.70	2.7566	23.080	26.291
Minimum	-0.9500	0.4700	47.9100	0.4523	4.4200	21.594
Std. Dev.	0.3862	2.0138	10.075	0.5123	3.6215	1.0091

The mean for all the dependent and independent variables are positive with the mean of ROAA that representing 16 Islamic banks in Malaysia used in this study is 0.64 with the maximum 1.4. The mean of asset quality (AQ), capital adequacy (CA), operating efficiency (OE) and bank size (BS) is 2.33, 7.71, 1.18 and 23.91 respectively. The mean value of other bank-specific variable; liquidity ratio is the highest (81.27) and varies considerably across banks and over the time between 135.7 and 47.91. The same ratio has the highest standard deviation with the value of 10.08. A high standard deviation signifies that the value spreads out further from the mean. Based from the measurement of liquidity, the value indicates that there is a huge gap between the loans or financing issued by different banks. Meanwhile, the ROAA ratio has the least standard deviation value of 0.39.

4.2 Correlation Analysis

Table 4 shows the correlation between the independent variables which indicates the strength of the relationship between two or more variables. The purpose of correlation matrix is to detect whether there is a multicollinearity problem between the independent variables used in this model. The correlation matrix shows that all the independent variables are not strongly related with each other, as the correlation value is less than 0.7 (the most common threshold) (Dormann et al., 2013).

Table 4. Correlation Matrix

Variable	AQ	LQ	OE	CA	BS
AQ	1.0000				
LQ	-0.0932	1.0000			
OE	0.1955*	-0.2048*	1.0000		
CA	0.5085*	-0.1224	0.4830*	1.0000	
BS	-0.1729*	0.3514*	-0.5733*	-0.6058*	1.0000

Note: *, ** and *** represent coefficients that are statistically significant at the 1%, 5% and 10% level, respectively.

4.3 Regression Analysis

This section shows the panel data regression analysis of Islamic banks financial performance and its dependent and independent variables, using OLS model. The results of regression analysis ad per Table 5.

Table 5. Results of Regression Analysis

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-3.445668	0.933165	-3.692454	0.0003
AQ	0.014696	0.014435	1.018103	0.3103
LQ	-0.000328	0.002691	-0.121777	0.9032
OE	-0.071402	0.059008	-1.210047	0.2282
CA	-0.016390	0.010256	-1.598146	0.1121
BS	0.165170	0.035904	4.600270	**0.0000**
Root MSE	0.295480	R-squared		0.411076
Mean dependent var	0.642588	Adjusted R-squared		0.379875
S.D. dependent var	0.386243	S.E. of regression		0.304158
Akaike info criterion	0.512069	Sum squared resid		13.96936
Schwarz criterion	0.685048	Log likelihood		-31.96555
Hannan-Quinn criter.	0.582310	F-statistic		13.17500
Durbin-Watson stat	1.153474	Prob(F-statistic)		0.000000

According to the results, R-squared is equal to 0.4111 indicates that 41% of the total variation in the ROAA of Islamic banks in Malaysia occurs because of the variations in the determinants of banks performance used in this study. The remaining 59% might be due to randomness and other variables which are not included in the model. Furthermore, F-statistics is 13.17, used to tests the overall significance of the regression model. The p-value equals to 0.00 which is less than 0.05, describes the model is statistically significant and useful for measuring the relationship between ROAA and independent variables. Only bank size is positively related with the bank performance, highly significant with the p-value 0.000, thus rejecting the null hypothesis. It means that bank size is an important factor that impacts the performance of Islamic banks in Malaysia. An increase of 1% in the bank size which is the total bank assets will cause the level of profit to increase about 0.1652%.

Despite of many literatures agreed on the positive relationship between capital adequacy and liquidity ratios with bank performance, this study found the opposite as these 2 variables have negative relationship with ROAA, but insignificantly correlated, hence accepts the null

hypothesis. The same goes with the other bank-specific variable which is asset quality as the variable unexpectedly has a positive relationship but also insignificant. The theory and literatures suggest that an increase exposure to asset quality or credit risk is normally associated with decrease of profitability. However, if the borrowers are able to repay the debt and interests, we can see from the evidence that the higher of this ratio will lead to the higher profitability of the banks (Srairi, 2009). For the operating efficiency, even though this study shows its negative relationship with bank performance as predicted, this variable is not significant in explaining bank performance, subsequently accepts the null hypothesis. The same hypothesis result applies to asset quality. From the result, the estimated model is converted as following;

$$ROAA_{it} = -3.4457 + 0.0147AQ - 0.0003LQ - 0.0714OE - 0.0164CA + 0.1652BS$$

According to the empirical result above, it shows that the bank size is the determinants of Islamic banks financial performance in Malaysia. The bank size which refers to the total assets of the bank, resulted a positive relationship with the bank performance. This result consistent with the findings of Idris et al. (2011), Masood and Ashraf (2012), Abduh and Idrees (2013), Flamini et al. (2009), Srairi (2009) and many more. There were large number of studies on bank performance or profitability that chose bank size as an independent variable to analyse the determinants. It indicates the importance of total assets in determining the level of bank's profitability since few decades ago. This positive effect emphasizes that larger banks take advantage of their position in negotiating the price for their input, therefore, reduce their average cost while improving the profitability (Idris et al., 2011). Besides that, larger bank size will fundamentally have better access to capital markets, lower cost of borrowing and be able to generate higher income. Notably, this result also identical to the theory of the Islamic finance as an adherence to Shariah principles, Islamic banks must invest in assets instead of trading in money (Jaara et al., 2021), with asset-backed transactions.

5. Conclusion

The aim of this study is to investigate and identify the factors that affect the financial performance of Islamic banks in Malaysia. By taking the data from 16 Islamic banks with total of 160 observations, the Ordinary Least Squares (OLS) method was used to analyse the findings. The results suggest that the bank size explaining the variation of financial performance for Islamic banking institutions in Malaysia.

Bank size is a determinant factor that influence the bank performance, Islamic banks should focus more on expanding the banks in order to achieved full benefits of economies of scale through the bank assets. The bank size may attract and put confidence in the eyes of the consumers when selecting the financial products and services as the competition is very high and many options are available within the financial market. In addition, many conventional banks have split their Islamic window to become subsidiaries and starts afresh as a full-fledged Islamic bank. This development is a response towards the impressive growth of global Islamic finance and Muslims conscience on their obligations to choose halal (permissible) and Shariah compliance products and services.

Nevertheless, there are still other factors that may affect the performance of Islamic banking in Malaysia that can be considered further in future studies. With the hope that more data would be available in the future, it is recommended to include microeconomics variables

as determinants such as GDP growth, inflation, money supply growth, market interest rate, tax rate, exchange rate, discount rate, government revenue and expenditures and import or export of goods and services, in order to identify the factors that could explain Islamic banks financial performance. Other than that, the comparison of profitability determinants between local and foreign Islamic banks incorporated in Malaysia can be considered. In addition, the comparison of the impact between the periods of prior, during and post Covid-19 pandemic can also be considered when the sufficient data is available in the future especially during the post pandemic period.

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